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Airport Regulation Inquiry  
Productivity Commission

12 September 2018

By email: [airports@pc.gov.au](mailto:airports@pc.gov.au)

Dear Commissioners

#### ECONOMIC REGULATION OF AIRPORTS INQUIRY

The Australian Finance Industry Association [AFIA] on behalf of the members of our Car Rental Group (Avis Budget; Bayswater Car Rental, East Coast Car Rental/Sixt, Europcar, Hertz, Redspot/Enterprise and Thrifty) welcomes the opportunity to inform the Productivity Commission's *Economic Regulation of Airports Inquiry*. Further detail on AFIA is available through: [www.afia.asn.au](http://www.afia.asn.au).

#### BACKGROUND

Collectively AFIA's Car Rental Group has a market size that generates more than \$1.4 billion of annual revenue and has 5.2 million rental transactions per year. Not all are directly impacted under current arrangements with airports in Australia as only five have on-airport operations. Nevertheless, all share a common interest in working with the Government to ensure airport authorities (in both capital city and regional locations) operate efficiently and in a way that does not abuse their market power in their dealings with users, including Car Rental Operators.

#### AFIA CAR RENTAL GROUP MEMBERS – POSITION SUMMARY

AFIA's Car Rental Group Members that have on-airport operations have identified concerns about the effectiveness of the airports regulatory regime given significant difficulties in dealings with airport authorities that they have experienced, including a range of behaviours consistent with the use of market power.

To inform AFIA's submission and give those concerns a framework to be measured, AFIA engaged Frontier Economics, a renowned economics consulting firm. Data was provided by AFIA Car Rental

Operator Members and used to model and assess the economic implications of the current regulation of the airports on car rental operators with flow-ons to their end-user car rental customers. The outcome is summarised below and a more detailed analysis contained in the Report produced by Frontier Economics and incorporated in our submission – see Annexure 1.

#### KEY FINDINGS

Economic modelling informed by the experience of AFIA's Car Rental Operator Members highlights:

- how airports exploit their market power with respect to car rental operators; and
- the benefits (particularly for the consumer) and other consequences of moving to a better regulatory regime that takes greater account of the power imbalance between airports and car rental operators at the airport.

More specifically, airports are important sources of customers for car rental operators. To secure access to these customers each operator must bargain with airport authorities for terminal access and other space to store vehicles.

Major Australian airports have a significant degree of market power in markets relating to use of core airports facilities. This is because Australian airports have natural monopoly characteristic, due to high fixed and sunk costs, and network economies relating to airlines. car rental operators have little option but to acquire access to airport facilities; as off airport solutions are generally unattractive to end-user customers.

In bargaining with car rental operators, airports can use a range of techniques to exploit their market power. Most obviously, they can charge operators high prices to gain access to passengers wishing to procure a rental car. Otherwise, their exploitation of market power is reflected in a lack of consultation, unnecessary investment, or a 'take it or leave it' approach to negotiation around the terms and conditions of access.

The Report produced for AFIA by Frontier Economics highlights that these concerns are far from theoretical.

Data collected from affected AFIA members indicates that, when measured on an average cost per transaction basis:

- charges to car rental operators result in costs per transaction that are commonly 3 to 5 times higher than downtown locations.

- Australian airports are by some measure the most expensive airports, close only to similarly regulated airports in New Zealand. All 14 Australian airports measured have higher charges than every US Airport (8 in total)<sup>1</sup>.

Consumers bear the brunt of these high charges, with as much as \$30 out of every \$100 paid to a car rental operator flowing straight through to airports.

#### PROPOSED SOLUTION

The present regulatory approach relies on a combination of price monitoring by the Australian Competition and Consumer Commission [ACCC], and the general access regime under the Competition and Consumer Act 2010.

AFIA's view is that there is sufficient evidence that the current regime does not constrain airports in their dealings with car rental operators. Monitoring does not currently include services provided to car rental operators, and Part IIIA applications for regulated access are likely to be costly and time consuming and provide little certainty of outcome. In addition, recent amendments to the promotion of competition test in Part IIIA means that it is likely to be more difficult for car rental operators to access – because declaration that lowered prices would not obviously meet the promotion of competition criterion trigger.

The Commission should further consider the option of enlivening negotiate-arbitrate models to provide for better terms of access to airports. The key characteristics of an approach that would give rise to genuine negotiations between car rental operators and airports include:

- a Code of Conduct that establishes a right to negotiate in good faith
- information provisions that support the negotiation process
- recourse to independent arbitration if agreement cannot be reached.

AFIA has considered the Commission's prior objections to compulsory negotiation and arbitration provisions. This includes that such provisions might hinder genuine negotiations. However, excessive arbitration is usually a symptom of a poorly-designed access framework; a well-designed framework will avoid arbitrations. In AFIA's view, this could be enhanced with recourse to alternative arbitration methods, such as "final offer" arbitration.

Finally, the likely net benefits from reform were considered and AFIA concludes that:

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<sup>1</sup> See Attachment 1

- there will be minimal costs associated with a negotiate-arbitrate regime, because the current regime already imposes costs and additional costs are likely to be 'one off' in nature
- there is little reason to conclude that access regulation would hinder efficient investment compared with the factual with price monitoring
- benefits would arise from lower prices for users of car rental services, as pass through of lower input costs would be almost certain.

In this regard AFIA acknowledges alignment with the solution recommended by the airlines as reflected in the submission made on their behalf by Airlines 4 Australia & New Zealand.

#### NEXT STEPS

We would welcome an opportunity to discuss our submission further or provide additional information.

Please contact me \_\_\_\_\_ or Alex Thrift, Economic & Senior Policy Adviser  
through 02 9231 5877.

Kind regards

Helen Gordon  
Chief Executive Officer

## International Price Comparison

Country	Airport Name	OAG Code	Cost Rank
New Zealand	Queenstown	ZQN	1
Australia	Sydney	SYD	2
Australia	Cairns	CNS	3
Australia	Alice Springs	ASP	4
Australia	Canberra	CBR	5
Australia	Brisbane	BNE	6
Australia	Darwin	DRW	7
Australia	Perth	PER	8
Australia	Mackay	MCK	9
Australia	Newcastle	NEW	10
UK	Heathrow	LHR	11
New Zealand	Christchurch	CHC	12
Australia	Melbourne	MEL	13
New Zealand	Auckland	AUK	14
France	Paris Roissy	CDG	15
Spain	Madrid	MAD	16
Australia	Adelaide	ADL	17
Australia	Rockhampton	ROK	18
UK	Edinburgh	EDI	19
Australia	Townsville	TSV	20
Australia	Coolangatta (Gold Coast)	OOL	21
New Zealand	Wellington	WLG	22
Italy	Rome Fiumicino	FCO	23
France	Geneva	GVA	24
Germany	Frankfurt	FRA	25
France	Nice	NCE	26
US	Palm Springs	PSP	27
Germany	Munich	MUC	28
France	Paris Orly	ORY	29
US	Los Angeles	LAX	30
US	San Francisco	SFO	31
Spain	Valencia	VLN	32
Italy	Milan Malpensa	MLP	33
Spain	Seville	SVQ	34
UK	Glasgow	GLA	35
UK	Gatwick	LGW	36
Spain	Barcelona	BLA	37
UK	Manchester	MAN	38
Benelux	Amsterdam	AMS	39
Germany	Stuttgart	STR	40
Italy	Milan Linate	LIN	41
Spain	Malaga	AGP	42
US	Chicago O'Hare	ORD	43
US	Detroit	DTW	44
Germany	Hamburg	HAM	45

10 SEPTEMBER 2018

**SUBMISSION TO THE  
PRODUCTIVITY COMMISSION  
INQUIRY ON THE ECONOMIC  
REGULATION OF AIRPORTS**

PREPARED FOR AFIA

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# CONTENTS

<b>Executive Summary</b>	<b>2</b>
An opportunity to take stock of airports regulation	2
Airports are unconstrained by regulation	2
The Commission should consider alternative light handed regulatory approaches	3
<hr/>	
<b>1 Introduction</b>	<b>4</b>
1.1 Background	4
1.2 Landside access	4
1.3 Purpose of this report	5
<hr/>	
<b>2 Airports exploit market power in dealing with car rental companies</b>	<b>6</b>
2.1 Many Australian airports have market power	6
2.2 Airports exploit market power with respect to rental car companies	10
2.3 Empirical analysis of the exploitation of market power	13
2.4 Conclusion	19
<hr/>	
<b>3 Remediating Airport market power</b>	<b>21</b>
3.1 The current regulatory framework is ineffectual	21
3.2 Price and quality monitoring offers little deterrence	22
3.3 A negotiate-arbitrate regime may provide a suitable remedy	23
3.4 Measures can be adopted to avoid automatic recourse to arbitration	25
3.5 Assessing the impact of the new framework	28
<hr/>	
<b>A International price comparisons</b>	<b>30</b>
<hr/>	
<b>B Declaration under Part IIIA access regime</b>	<b>32</b>
Markets in which car rental services are supplied	34
What does it mean to “promote competition”?	35
The circumstances in which declaration could promote competition	36

## Tables

<b>Table 1:</b> Key elements of a negotiate-arbitrate regime	24
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## Figures

<b>Figure 1:</b> Loss for consumers from airport monopoly in the market for car rental services supplied at the airport	11
<b>Figure 2:</b> Level and composition of costs per transaction, by Australian airport (2017)	16
<b>Figure 3:</b> Average cost per transaction (2017) and annual growth, 2015-17	17
<b>Figure 4:</b> Comparison of airport and downtown charges, by city	18
<b>Figure 5:</b> Average transactions cost per rental, averaged per country	19

## Boxes

<b>Box 1:</b> Examples of use of market power	11
<b>Box 2:</b> Airports charges to car rental operators	14
<b>Box 3:</b> Excessive arbitrations in telecommunications was a special case	26

# EXECUTIVE SUMMARY

## An opportunity to take stock of airports regulation

The Productivity Commission's review of airport regulation represents a further opportunity to take stock of the effectiveness of the regulatory framework that was set up in 2002. With more than 15 years of experience with the regime, the information base on the outcomes of the "light handed" price monitoring regime is now sufficient to draw conclusions.

The Australian Finance Industry Association [AFIA] has asked Frontier Economics to consider the effectiveness of the airports regulatory regime, in light of its concern that its Car Rental Operator Members that operate on-airport report significant difficulties in dealing with airport authorities, including a range of behaviours consistent with the use of market power.

AFIA's submission highlights:

- how airports exploit their market power with respect to our Car Rental Operator members and
- the benefits (particularly for the consumer) and other consequences of moving to a better regulatory regime that takes greater account of the power imbalance between airports and car rental operators at the airport.

## Airports are unconstrained by regulation

Airports are important sources of customers for car rental operators. To secure access to these customers each operator must bargain with airport authorities for terminal access and other space to store vehicles.

Major Australian airports have a significant degree of market power in markets relating to use of core airports facilities. This is because Australian airports have natural monopoly characteristic, due to high fixed and sunk costs, and network economies relating to airlines. car rental operators have little option but to acquire access to airport facilities; as off airport solutions are generally unattractive to end-user customers.

In bargaining with car rental operators, airports can use a range of techniques to exploit their market power. Most obviously, they can charge operators high prices to gain access to passengers wishing to procure a rental car. Otherwise, their exploitation of market power is reflected in a lack of consultation, unnecessary investment, or a 'take it or leave it' approach to negotiation around the terms and conditions of access.

This submission highlights that these concerns are far from theoretical. Data collected from affected AFIA members indicates that, when measured on an average cost per transaction basis:

- charges to car rental operators result in costs per transaction that are commonly 3 to 5 times higher than downtown locations.
- Australian airports are by some measure the most expensive airports, close only to similarly regulated airports in New Zealand. All 14 Australian airports measured have higher charges than every US Airport (8 in total).

Consumers bear the brunt of these high charges, with as much as \$30 out of every \$100 paid to a car rental operator flowing straight through to airports.

## The Commission should consider alternative light handed regulatory approaches

The present regulatory approach relies on a combination of price monitoring by the Australian Competition and Consumer Commission [ACCC], and the general access regime under the *Competition and Consumer Act 2010*.

Our view is that there is sufficient evidence that the current regime does not constrain airports in their dealings with car rental operators. Monitoring does not currently include services provided to car rental operators, and Part IIIA applications for regulated access are likely to be costly and time consuming and provide little certainty of outcome. In addition, recent amendments to the promotion of competition test in Part IIIA means that it is likely to be more difficult for car rental operators to access – because declaration that lowered prices would not obviously meet the promotion of competition criterion trigger.

The Commission should further consider the option of enlivening negotiate-arbitrate models to provide for better terms of access to airports. The key characteristics of an approach that would give rise to genuine negotiations between car rental operators and airports include:

- a Code of Conduct that establishes a right to negotiate in good faith
- information provisions that support the negotiation process
- recourse to independent arbitration if agreement cannot be reached.

We have considered the Commission's prior objections to compulsory negotiation and arbitration provisions. This includes that such provisions might hinder genuine negotiations. However, excessive arbitration is usually a symptom of a poorly-designed access framework; a well-designed framework will avoid arbitrations. This could be enhanced with recourse to alternative arbitration methods, such as "final offer" arbitration.

Finally, we consider the likely net benefits from reform. We conclude that:

- there will be minimal costs associated with a negotiate-arbitrate regime, because the current regime already imposes costs and additional costs are likely to be 'one off' in nature
- there is little reason to conclude that access regulation would hinder efficient investment compared with the factual with price monitoring
- benefits would arise from lower prices for users of car rental services, as pass through of lower input costs would be almost certain.

# 1 INTRODUCTION

## 1.1 Background

The Productivity Commission [Commission] is undertaking its third review of the regulation of Australian airports previously operated by the Federal Airports Corporation.

The 2011 Commission inquiry examined the effectiveness and efficiency of the economic regulation and quality of service monitoring regime for airports and found that the regulatory oversight had been effective and should be maintained for Brisbane, Melbourne, Perth and Sydney airports, with a further review to be conducted in 2018.

The terms of reference for the inquiry indicate that the purpose of this 2018 Inquiry is to determine the effectiveness and efficiency of the current arrangements and determine whether they remain appropriate.<sup>1</sup>

## 1.2 Landside access

The Issues Paper for the inquiry<sup>2</sup> devotes most of its attention to aeronautical services. However, in section 5, the Commission identifies possible concerns with “landside access”:

*Airports are monopoly providers of on-airport car parking and of ‘landside access’ to terminal forecourt areas, including for taxis and rental vehicles. High prices and profits from these services could reflect abuses of market power. They could also reflect the opportunity cost of airport land (the value of alternative uses of the land) and the high value that airport users place on access to airports. Or a combination. Of these explanations for high prices, only the abuse of market power would be a rationale for government intervention.<sup>3</sup>*

The Commission particularly notes the incentives an airport may have in limiting the availability or increasing the prices of services that might be considered substitutable with the airport’s car parking services. It mentions car rental services within this group.<sup>4</sup>

Unfortunately, the Commission has little data by which to assess prices charged and profits earned by airports in their dealings with car rental operators. The ACCC, which is responsible for airport monitoring, notes the following:

*Unlike aeronautical activities, landside access revenue data is provided by airports on a voluntary basis. As a result, the data is not fully consistent in terms of its coverage of services across the airports. Indeed,*

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<sup>1</sup> Productivity Commission, *Issues paper – economic regulation of airports*, 2018, p. iii.

<sup>2</sup> *ibid.*

<sup>3</sup> *ibid.*, p. 19

<sup>4</sup> *ibid.*, p. 19

*revenue from car rental operations is not reported because airports have inconsistent methods for reporting this information.*<sup>5</sup>

### 1.3 Purpose of this report

AFIA considers that the lack of information and effective regulation of airports with respect to car rental operators constitutes a major oversight in the present light-handed regulatory regime. Its on-airport Car Rental Operator members report significant difficulties in dealing with airports, including a range of behaviours consistent with the use of market power.

Frontier Economics has been commissioned by AFIA to prepare a Report outlining to the Commission:

- how airports exploit their market power with respect to its Car Rental Operator members and
- the benefits (for the consumer, in particular) and other consequences of moving to a better regulatory regime that takes greater account of the power imbalance between airports and car rental operators at the airport.

The remainder of this Report is structured as follows:

- In section 2, we outline that many Australian airports hold positions of market power, unencumbered by any material countervailing power of the customers of car rental operators. We explore the consequences of this market power and its impact on prices charged.
- In section 3, we highlight why the current regulatory regime is inadequate, and consider options for remedying airports' market power in a relatively light-handed way
- In the annexes, we provide further details on:
  - the ineffective constraint offered by existing regulation
  - the price comparisons highlighted in section 2.

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<sup>5</sup> ACCC, Airports Monitoring report 2016-17, p. 141.

## 2 AIRPORTS EXPLOIT MARKET POWER IN DEALING WITH CAR RENTAL OPERATORS

### 2.1 Many Australian airports have market power

As the Commission notes, the rationale for government intervention in commercial relationships is usually limited to significant ‘market failures’. In this section, we set out that the market failure arises because Australian airports have natural monopoly characteristic, which gives these airports significant market power in dealing with car rental operators in the markets in which they operate.

#### 2.1.1 Airports have natural monopoly characteristics

Airports produce a number of different services that are supplied to different users. The main services they provide include:

- **Aeronautical services** – this includes access to runways, terminals and other airside infrastructure, and are principally provided to airlines.
- **Landside access to the airport** – this includes the provision of roads, parking and loading spaces, and are provided to airport users, car rental operators, and transport providers (such as taxis).
- **Retail tenancies** – these services are provided to retailers operating at the airport.
- **Property services** – these are provided to entities that use the airport for business operations, such as logistics companies, and airline catering companies.

The natural monopoly characteristics of airports suggest that they are likely to hold market power in some, or all, of the services they provide. The monopoly characteristic of Australian airports stems from their high fixed and sunk costs, and their characteristics as a network.

- **Fixed and sunk costs** – airport services are provided using facilities that require substantial upfront investments in capital with limited alternative use beyond providing airport services, irrespective of the number of airlines or passengers served. Services that involve high fixed and sunk costs tend to be natural monopolies.

For instance, investments in runways and terminal facilities involve sunk costs because the facilities have no other alternative use. They are also lumpy and do not vary with incremental increases in output until some significant threshold is reached. Furthermore, it is likely to be cheaper for an airport to invest in expansions rather than to duplicate airport facilities. This suggests that a single airport is likely to deliver airport services more efficiently than multiple airports operating in competition.

- **An airport as a network** – an airport is a facility at which various transport routes (predominantly air transport) intersect to form a network. The network enables passengers and freight to transfer from one transport route to another. Networks also tend to be natural monopolies; that is, they provide services that can most efficiently be provided by one enterprise.

The intuition behind this tendency is straightforward. For example, if passengers and freight arrive in Sydney by one means of transport and need to transfer to other transport routes, it saves time and expense if those other transport routes converge at the same point. As this is true of all routes by

which passengers and freight arrive in Sydney, airport services in Sydney will have strong natural-monopoly characteristics. This has led to the development of hubs and bases which creates network benefits for both airlines and passengers (particularly in relation to international and long-haul flights).

While the natural monopoly characteristics of airports create a presumption that they have market power in the provision of services to car rental operators, the extent of that market power, and whether or not the airport is exploiting it, will depend on the particular market(s) in which the airport is providing those services. Before undertaking this assessment, we set out general principles for defining markets

### 2.1.2 Principles for defining relevant markets

Australian competition jurisprudence has developed clear principles for market definition. The often cited case of *Queensland Wire Industries v BHP* provides as follows:

*A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them ... Within the bounds of a market there is substitution – substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive.<sup>6</sup>*

Ultimately, the question of market definition turns on the analysis of substitution. Substitution involves switching from one product to another in response to a change in the relative price, service or quality of two products (holding unchanged all other relevant factors, such as income, advertising or prices of third products). A key feature of market definition is that it includes both demand and supply-side substitution. That is, consideration must be taken of alternative products that are available to consumers, and also alternative sources of product supply.

In addition, market definition is purposive. That is, the definition of a relevant market cannot be separated from the particular competitive issue under investigation. As such, when undertaking a market definition exercise, it is important to be clear about why the market is being defined. In the present case, we are concerned about whether airports are exploiting market power in their dealings with car rental operators. We should start the market definition analysis by considering the services that airports provide to these entities.

In the next section, we apply these principles to define relevant markets for the purpose of assessing whether airports have been exploiting market power in their dealings with car rental operators.

### 2.1.3 A market for the supply of airport space to car rental operators

We begin our analysis by considering the services that airports provide to car rental operators. The key inputs that car rental operators commonly purchase from airports in order to provide rental car services to passengers are:

- access to car parking bays outside the terminal
- access to retail counter space inside the terminal.

<sup>6</sup> *Queensland Wire Industries v BHP* (1989) 167 CLR at 177.

Airports may also provide other supporting infrastructure to car rental operators, including facilities for car maintenance, cleaning and servicing. These may be provided within the boundary of the airport, and in such cases, access to those facilities must be purchased from the airport.

So is the service provided by airports to car rental companies substitutable for other services, if given a small but not insignificant price incentive?

- On the supply side, the only relevant supply of car parking and counter space at an airport is the airport operator itself. It is difficult to imagine how any other company could provide access to this space since, by definition, it involves access to infrastructure under the sole control of the airport.
- On the demand side, car rental operators that wish to serve airport users have the option of locating outside the airport. However, in our view, this is unlikely to be a realistic substitute since we expect that customers place significant value on the convenience of being able to pick up and return vehicles directly at the airport. While there may be some customers that would be willing to rent vehicles from off-airport operators, there is clearly a material cost in doing so.

Furthermore, if a car rental operator were to locate outside the airport, a competitive service would require an effective means of transferring customers between the airport and the off-airport location of the rental car operator. This would involve either the customer taking public transport or, more likely, the car rental operator providing its own transfer service. In our view, neither option is likely to provide a sufficient constraint on an airport's pricing to be considered in the same market. This is because:

- most customers would be unwilling to take public transport to an off-airport car rental operator due to the additional time, effort and expense involved
- provision of any transfer service by the car rental operator requires landside vehicle access to the airport which, by definition, is controlled by the monopoly airport operator.

On this basis, for the purposes of this Report, we define a market for the supply of airport space (including car parking bays and retail counter space) to car rental operators. The geographic scope of this market is limited to each individual airport, or at least each of the major metropolitan airports in Australia.

Of course, for any particular matter or allegation, greater attention would need to be paid to the circumstances at each individual airport. However, we note that this market definition is consistent with the findings of the ACCC in its consideration of an application for authorisation by Hertz, Avis, Thrifty, Budget and Europcar in 2010.<sup>7</sup> In this case, the car rental operators proposed to collectively negotiate with Westralia about the price, terms and other conditions at which the car rental companies would acquire airport facility services at Perth airport. The ACCC determined that there was a market for the supply of airport space (car parks and counter space) at Perth airport to car rental companies, noting as follows:

*The ACCC considers that for car rental companies there is likely to be, at best, limited substitutability between retail space and car parking space offered to them at Perth airport and that available at other locations. This is because many customers hiring vehicles at the airport are likely to want to rent a car directly after arriving in Perth by plane and/or to return a car directly*

<sup>7</sup> ACCC, *Objective notice in respect of a collective bargaining notification lodged by Hertz Australia Pty Limited on behalf of a group of car rental companies operating at Perth airport*, 16 July 2010.

A similar conclusion was reached by the ACCC in its assessment of an application for collective bargaining by car rental operators at Mackay Airport in 2009 (see: ACCC, *Assessment – Collective bargaining notification lodged by Hertz Australia Pty Limited*, 7 December 2009).



*to the airport before departing from Perth by plane. These customers would place significant value on the convenience of being able to pick up and/or return their rental vehicle at the airport.<sup>8</sup>*

## 2.1.4 Airports have market power in their dealings with car rental operators

Economics view market power and competition as opposites. A firm's market power is its freedom to set prices and other supply conditions independently of the constraints that would otherwise be imposed by competitors. This is explained in the famous words of the United States Attorney-General's National Committee to Study the Antitrust Law:

*The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new or potential entrants into the field, would keep this power in check by offering or threatening to offer effective inducements ...*

In the absence of effective competition, an individual seller, or a group of sellers acting in concert, can exercise market power in choosing its level of profits by giving less and/or charging more.

The relevant question in this case is whether airports have market power in the market for the supply of airport space to car rental operators. An airport will possess this market power if they can profitably charge car rental operators for access to car parking and counter space in excess of the efficient cost of supply, and/or reduce the quality of these services without a commensurate reduction in price, for a significant period of time. In our view, there are several factors to suggest that is near-certain:

- **Airports are monopolies** – by definition, airports are the only companies that can supply on-airport car parking and counter space to car rental operators; that is, there is no possibility for a car rental operator to obtain these services from an alternative on-airport supplier.
- **Car rental operators have little countervailing power** – In its 2010 decision, the ACCC noted that a fully-functional airport requires car rental operators servicing passengers at the airport. While we agree with this sentiment, airports have many choices ('outside options') as to which car rental operators operate such that no one is likely to have countervailing power to bargain for lower prices. This is supported by evidence provided to us by the AFIA on-airport Car Rental Operator Members which indicates that airports around Australia make "take it or leave it" offers.
- **Serving airport customers is an important source of revenue for car rental operators** – Although car rental car operators have, in theory, a choice as to whether they operate at airports, or serve airport user customers, the importance of airport-related business to their overall business influences to a large extent the degree to which airports can exercise market power in their dealings with them. In particular, we understand that in many cities, around 50% of a car rental operator's revenue comes from customer demand at airports.

This is consistent with the findings of the ACCC, which has previously held that Perth Airport (operated by Westralia) and Mackay Airport possess market power in their dealings with car rental operators.<sup>9</sup>

<sup>8</sup> *ibid.* This conclusion differs somewhat from that reached in an earlier authorisation application relating to Sydney Airport, where the market was found to be "greater than Sydney Airport". However, a conclusion on market definition was not reached. See <https://www.accc.gov.au/system/files/public-registers/documents/D05%2B12713.pdf>, p. 10.

<sup>9</sup> ACCC, *Objection notice in respect of a collective bargaining notification lodged by Hertz Australia Pty Limited on behalf of a group of car rental companies operating at Perth airport*, 16 July 2010

On the basis of these factors, we find that most larger airports are almost certain to have market power in the market for the supply of car parking bays and retail counter space to car rental operators. Like any monopoly supplier of goods and services that is not subject to price regulation, this provides a strong *a priori* case that airports will set a price and level of output that maximises their profits from providing car rental facilities at the airport.

## 2.2 Airports exploit market power with respect to car rental operators

### 2.2.1 Principles

There are a number of ways in which airports can exploit their market power. Like any monopoly supplier of goods or services, we expect that airports set a price and level of output that maximises their profits from providing car rental facilities. This pricing decision will not occur in the abstract from the prices and output of complementary services, such as aeronautical services, car parking and other retail space.

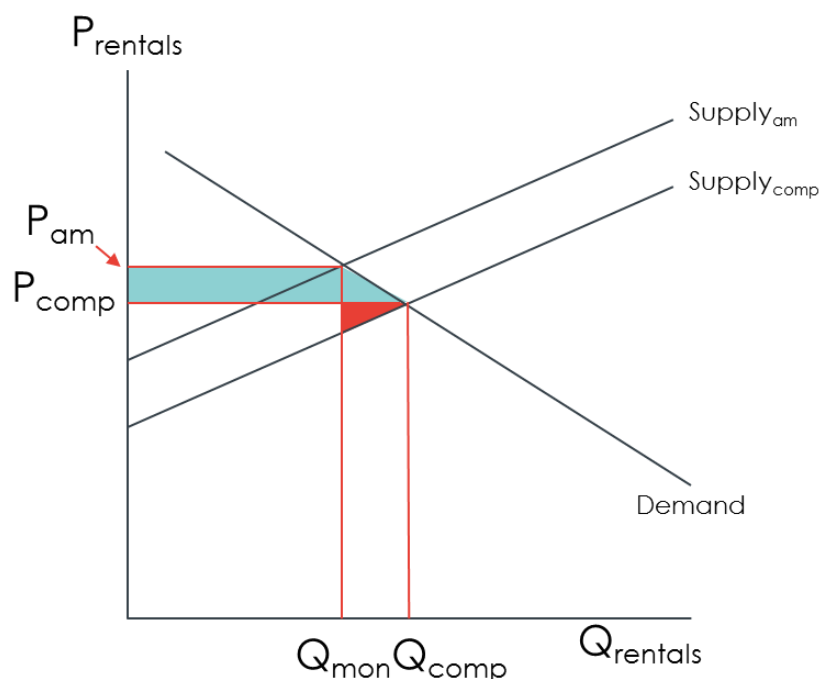
The airport is likely to have little interest in restricting access to car rental operators, as it can extract monopoly profits from competing car rental operators through high charges. The impact of the high prices will be felt in the market in which car rental operators compete. Higher airport charges are passed through to end user customers where they enter into operators' marginal cost curves (leading to a 'shift' in the supply curve from  $\text{supply}_{\text{comp}}$  to  $\text{supply}_{\text{am}}$  in **Figure 1**). This will lead to a loss of welfare to end-user customers – who pay more to rent vehicles or cease renting vehicles entirely (blue shaded area in **Figure 1**). Determining the size of the loss of consumer surplus or deadweight loss<sup>10</sup> depends on how excessive charges are, and the supply and demand elasticities in the downstream market for car rental services.<sup>11</sup>

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<sup>10</sup> The sum of the small blue and red triangles.

<sup>11</sup> Note that given reasonably free entry in car rental supply, one would also expect the long run supply curve to be relatively flat, so that the burden of higher prices is likely to fall almost entirely on customers.

**Figure 1: Loss for consumers from airport monopoly in the market for car rental services supplied at the airport**



Source: Frontier Economics

## 2.2.2 Issues in practice

The four main issues identified by car rental operators relating to the use of market power are:

- charging excessively for services, to which we turn in section 2.3
- under-investing in infrastructure, or excessive investment costs
- the allocation of risk towards car rental operators
- refusing to enter into commercial negotiations regarding terms and conditions of access.

We have documented some examples of how airports use their market power against car rental operators in **Box 1**:

### **Box 1:** Examples of use of market power

We asked AFIA for information on how its on-airport Car Rental Operator Members had experienced the use of market power by airports, aside from high prices. Some de-identified examples are supplied below.

#### **On the process of negotiation of fees with airports**

*“They are not commercial negotiations at all. We have no leverage as the airport knows we need to be there and so there is no meaningful negotiation. There have been occasions where we have tried to negotiate on issues which we think create an unfair outcome for consumers and have literally been told that if we are still on the airport the next day that we are deemed to have accepted the concession agreement as presented.”*

*“Anything which is critical to the operation is not negotiated.”*

*“Normally during a tender they would include the airport’s fee expectations and if that is not met (or a competitor comes in higher) it would go into individual negotiations that would be very one-sided and then often a ‘take it or leave it’ attitude. Airports are seeking to expand the revenue inclusions to include rents starting in another location that may return the vehicle at the airport and any rental within a specified radius of the airport. In addition, airports are seeking to include off airport rental companies that are an affiliated or associated company to an ‘on airport’ operator.”*

#### **On airport concession fees and revenue definition**

*“At all airports we pay a concession fee to the airport on the revenue we transact there. The definition of revenue is a real pressure point and very rarely amended...In one case the airport definition is extremely broad and requires that we pay a concession fee to them on damage excess and damage repair charges that customers have to pay after an accident.”*

*“We’re trying to improve the damage charging process for the consumer’s benefit and to uphold commitments we’ve made to the ACCC by installing central damage cameras at the airports. The cameras will capture the vehicle condition at the beginning and end of the rental. Some airports are refusing to install cameras at all and others have taken over 12 months to work with us on a solution. Only Darwin and Melbourne (not operational yet though) have installed cameras at this point. The charges each of us will pay for the communal cameras will be enough for the airport to recoup their initial outlay in 1 year and then the additional years are on track to be profit.”*

#### **On justifications for price increases**

*“The prices will go up by more than CPI but the airport will refuse to limit their increases to CPI and we receive no benefit of investment back into car rental facilities from any increase in fees paid.”*

*“Very few or poor ones. Mostly linked to upgrades made to in-terminal services, which car rental companies do not benefit from. Over 10 years very limited improvements have been made to car rental facilities provided by the airports and most of these have been funded by the rental industry either directly or by increased concession fees and rent.”*

#### **On comparisons with off-airport negotiations**

*“In an off-airport negotiation there are meaningful negotiations across a range of issues – rent, rent reviews, reporting obligations, condition obligations, dispute mechanisms such as independent rent review, comparisons to other market rents, willingness to adjust items such as accounting dates, landlord contributions, rent free period. Nothing meaningful is up for negotiation with an airport operator.”*

*“Leases that are off airport land include much more security of tenure and reduced rights of the Lessor to terminate or relocate.”*

*“In off airport rent review negotiations market price and market competition balance the power of negotiation as it’s possible to move locations without impacting our businesses. With the airports, we must be present or lose our business.”*

#### **On the efficiency of airport investment**

*“Improvements that are made are charged to us typically through rent. They are slow to make improvements and we have no visibility of the costs before they are passed to us and none of the benefits with any external providers are passed on. For example in the camera agreements we*

would expect to receive the benefits of KPIs and SLAs around uptime and maintenance etc but our contract with the airports have none of these standard clauses yet we are paying for the services (and presumably at a mark up). However some airports (such as Adelaide) have refused point blank to install cameras.”

“Generally not defined although they do have minimum appearance standards for desks and car park booths. Any work or investment taken by the airport on behalf of operators is at cost we could all do substantially less if given the opportunity.”

#### **On unilateral action by airports to move facilities for car rental operators**

“[Airports] have the ability to move our business (e.g. carpark area) at a cost to us. There is no adjustment in fees when this occurs. Often a forced relocation leads to an increase in cost with no scope for statutory compensation. In addition, there is no dispute resolution process.”

#### **On minimum annual revenue guarantees and the impact on risk allocation**

“This can vary by rental company and airport but generally is set on the prior year’s trading at 80% to 90%. Conceptually there is no need for high minimums; they are set to simply favour and protect the airport in times of negative growth underpinning their profits. The impact to the rental companies is the risk of not meeting the minimums and having to pay these fees regardless of economic downturns, passenger declines, adding additional operators or strong price competition.”

#### **On customer impact**

“The customers are paying the costs as the rental industry must continue to pass through the cost increases. This can be seen in the increase of Premium Location Fees at the airports. Fees have increased some 50% in the past 3 to 5 years.”

*Source: AFIA on-airport Car Rental Operator Members*

## **2.3 Empirical analysis of the exploitation of market power**

### **2.3.1 The Commission’s request for information**

The Commission seeks evidence on the extent of market power held by Australian airports in on-airport car parking and landside access services, and constraints on the abuse of market power (Information request 10). This includes evidence on the effectiveness of price monitoring for on-airport car parking and landside access (Information request 11), and evidence that could be used to determine whether airport operators are abusing market power in car parking and landside access.

As we have noted, space for car rental operators is not explicitly captured under the current monitoring framework.<sup>12</sup>

In our view, the most appropriate way to assess whether airports have abused their market power by earning excessive profits is to measure profits with respect to the whole of their (passenger relevant) operations. In a regulatory context, this is generally referred to as assessing a single till.<sup>13</sup> If the airport

<sup>12</sup> We are unclear whether the ACCC’s monitoring of car parking charges includes revenues and costs associated with renting long-term spaces to car rental operators.

<sup>13</sup> And sometimes a “hybrid till” to differentiate from an airport’s supply of services to customers other than airport passengers.

takes into account the inter-dependencies between customer groups in its pricing, then it is effectively meaningless to separately consider the profits of “aeronautical” services charged to airlines, and “non-aeronautical” services charged to other airport users including car rental operators.

In summary, the total profits of the airport should be considered as this is the best comparison by which one can measure the exercise of market power.

Other analysis we have conducted suggests that the four monitored Australian airports have exercised a considerable degree of market power across their operations; that is, comparing revenues and costs of aeronautical and non-aeronautical services together.<sup>14</sup>

### 2.3.2 Information collected

To assist the Commission, we sought data from AFIA on-airport Car Rental Operator Members on the charges levied at key Australian airports, other Australian locations and international airports.

In Box 1: Box 2: a description of the airports charging approach.

#### Box 2: Airports charges to car rental operators

Car rental operators incur a number of charges when operating their businesses at Australian airports. These charges can include:

- A concession fee, which is charged as a percentage of revenue earned. These account for the majority of the payments to airports. Qualifying revenues may be defined differently by each airport.
- Terminal rental fees for the operation of desks
- Terminal office rent (if required)
- Car parking fees for the long term rental of car parks (at which car rentals must be stored for convenient access for customers)
- Audit costs (associated with confirmation of revenues for measurement of concession fees)

Often, car rental operators are also subject to minimal annual guarantees relating to concession payments.

*Source: AFIA on-airport Car Rental Operator Members*

As the Commission notes, the primary analytical issue is the appropriate benchmark for charges. The charges by airports might reflect use of market power, locational rents, or both.

Locational rents are rents that would exist even if the market were competitive. Locational rents arise if the space or land available at the preferred location for an economic activity is limited and users are prepared to pay a premium (though not because of artificial restrictions). For instance, in the absence of airport market power, we expect that prices charged by car rental operators at the airport will be higher than the prices charged by the same businesses in – say – a car rental location in the suburbs.

<sup>14</sup> Frontier Economics, *The profitability of Australian price-monitored airports*, 2018.

This price differential – or locational rent – derives from the attractiveness of operating at the airport and the scarcity of space within the airport terminal.<sup>15</sup>

The only feasible means to determine which rents are locational and which reflect monopoly behaviour is to determine a suitable pricing benchmark from a market in which there is either:

- (more) competition for the business of car rental operators, but is otherwise like an airport; or
- from a market in which charges are regulated to reflect efficient costs (as a surrogate for competition).

Of course, such benchmarks are difficult to find in practice. It is difficult to conceive of competition for the supply of airport services to a car rental operator.

In our view, a possible benchmark for an airport is another high value location for a car rental operator – for example, a CBD or inner metropolitan location. In such locations, land prices are relatively high but (unlike airports) there is access to a significant number of potential renters of suitable land.

International airports provide another possible benchmark. This is because many other major international airports are either regulated or are in government ownership with an implied constraint on monopoly pricing. Of course, such comparisons must be treated with some caution as services offered may vary across a range of other cost and service characteristics.

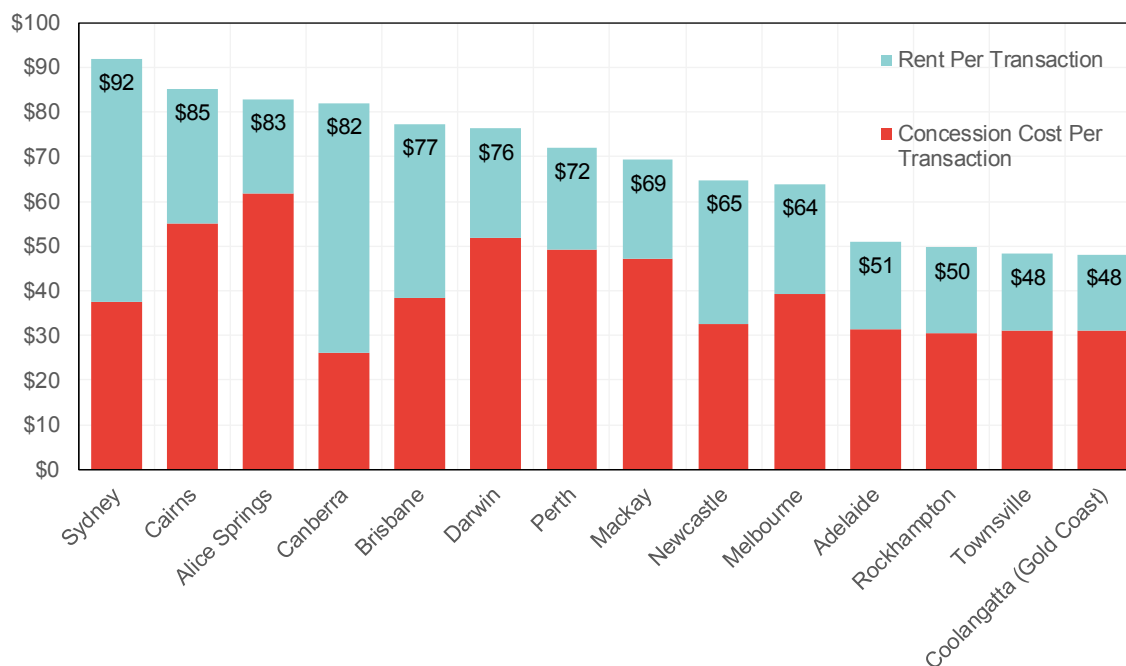
### **2.3.3 Domestic comparisons indicate significant divergence between airports**

A comparison of charges across airports in Australia is shown in **Figure 2**.

The data indicates clear disparities across airport locations. Sydney tops the total costs per transaction, with charges 40% more costly than in Melbourne, and over \$20 more per transaction than the Australian average.

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<sup>15</sup> It may also reflect the opportunity cost of the airport land, although under the terms of the privatisations airports only lease the land and must retain the aeronautical purposes of the land.

**Figure 2: Level and composition of costs per transaction, by Australian airport (2017)**

Source: AFIA on-airport Car Rental Operator Members

Data was also collected on airport costs to car rental operators for the 2015 year. This data highlights that charge growth continues to be strong (as shown in **Figure 3**) even among airports that already had relatively high charges.

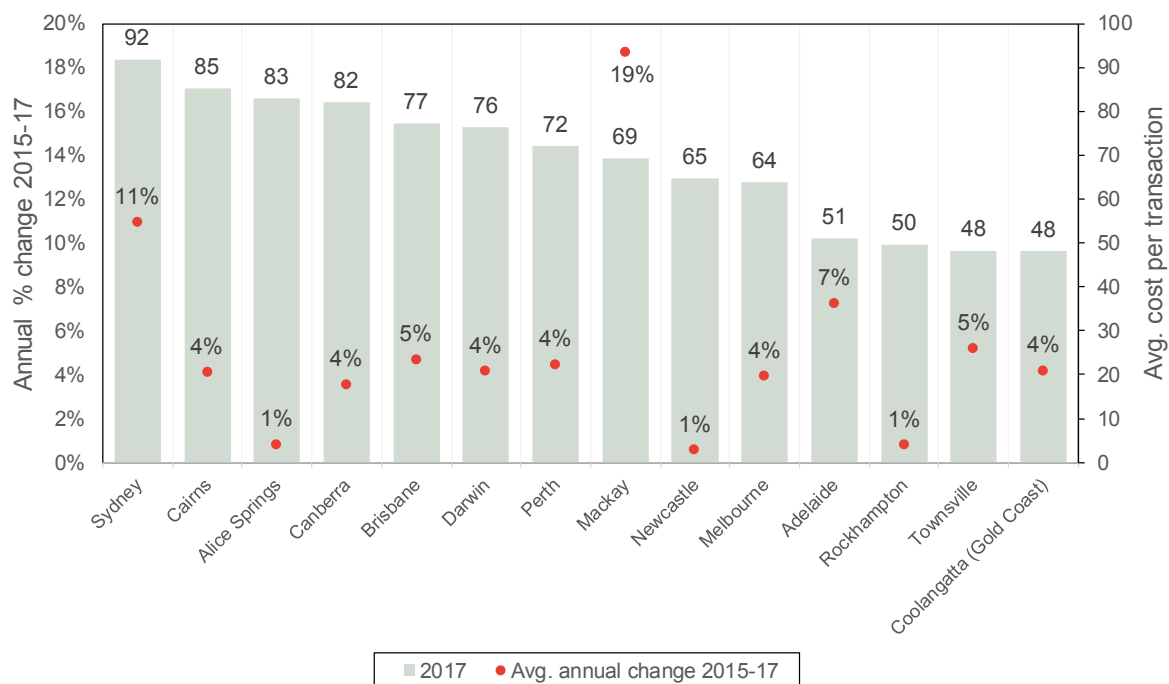
For example, Sydney's growth of 11% per year contrasts with:

- passenger growth of 4.1% per year<sup>16</sup>
- consumer inflation of 1.6% per year over the two calendar years from 2015.<sup>17</sup>

<sup>16</sup> <https://www.sydneyairport.com.au/investor/company-information/company-overview/performance-highlights>

<sup>17</sup> <https://www.rba.gov.au/calculator/financialYearDecimal.html>



**Figure 3: Average cost per transaction (2017) and annual growth, 2015-17**

Source: AFIA on-airport Car Rental Operator Members

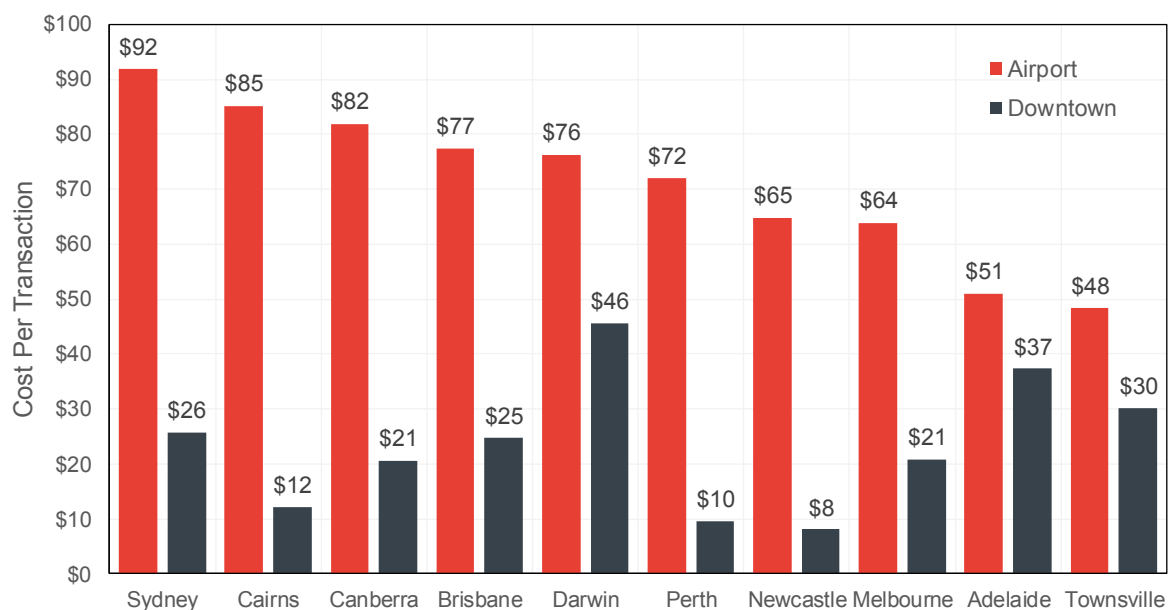
Further information supplied by AFIA on-airport Car Rental Operator Members indicates that minimum annual revenue guarantees have grown on average across airports at over 5% annually consistently for the last 7 years.<sup>18</sup>

### 2.3.4 Domestic comparisons show airport charges are well above downtown charges

We further received information from AFIA's Car Rental Operator Members on how charges levied at airports compared to downtown locations. As noted earlier, downtown locations are also high value car rental locations and so can provide a reasonable proxy for the comparative value of airport locations. However, a key difference is that downtown locations charge no "concession fees" only rental payments for leased land and facilities. This perhaps indicates the extractive nature of the concession fees used by airports.

**Figure 4** indicates a very significant gap between airport and downtown locations based on average costs per transaction. In major airports – Sydney, Melbourne, Brisbane and Perth – charges are between 3 and 7 times those in downtown locations. For smaller airports, variations tend to be smaller, although large variations are still observable at Cairns, Canberra and Newcastle.

<sup>18</sup> AFIA data.

**Figure 4: Comparison of airport and downtown charges, by city**

Source: AFIA Car Rental Operator Members

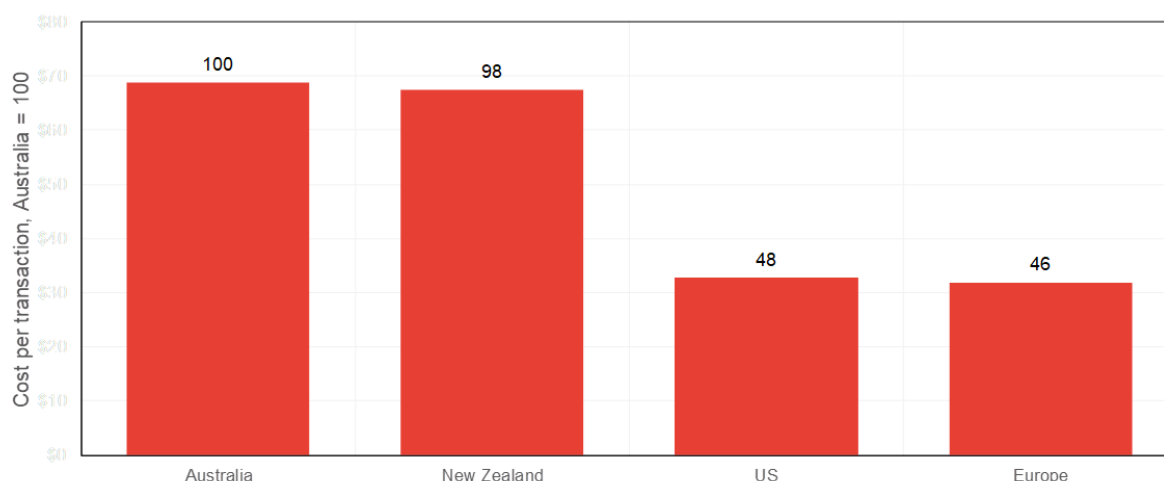
To some degree, the higher cost per transaction is likely to be offset by a higher number of transactions (and so revenues) for car rental operators. However, airports appear to be able to appropriate a significant proportion of that additional value, compared to where operating land is also expensive but more competitively supplied.

### 2.3.5 International comparisons show price monitored airports have much higher charges

AFIA was able to collect information on average transaction costs for 2017 at 71 domestic and international airports, across nine countries. This included 14 Australian airports (the 10 above plus a further 4 for whom downtown comparisons were not possible).<sup>19</sup>

We first compared charges on average across the US and European Union. This indicated that average transactions costs are distinctly higher in Australia and New Zealand. Not coincidentally, both countries have similar monitoring regimes with no direct constraints on charges.

<sup>19</sup> Adelaide, Brisbane, Canberra, Melbourne, Coolangatta (Gold Coast), Perth, Sydney, Newcastle, Cairns, Townsville, Darwin, Alice Springs, Rockhampton, Mackay.



In fact, Australia has 9 of the top 10 airports on the list, with Queenstown (NZ) the most expensive.<sup>20</sup> All 14 Australian airports measured have higher charges than every US Airport (8 in total).<sup>21</sup>

### 2.3.6 Impacts on consumers

Ultimately, consumers of car rental services bear the brunt of high prices.

Economics suggests that pass through of high input costs in competitive markets with uniform cost increases is likely to be close to 100%, at least in the longer term.<sup>22</sup> This also seems to be borne out in charging, with the pattern of retail pricing largely reflecting the charges described in **Figure 4**. Car rental operators impose location surcharges of around 30% at Sydney Airport, around 25% at other major metropolitan airports such as Melbourne and Canberra, and around 20% at major regional airports.<sup>23</sup> In comparison, location surcharges at downtown locations tend to be around 5-6%.

## 2.4 Conclusion

To summarise the findings of this section:

- There are strong *a priori* reasons to believe that many Australian airports will hold positions of market power that can be exploited with reference to car rental operators.
- Car rental operators have little countervailing power in the markets in which they operate.
- The relatively unconstrained behaviour of airports means that we should expect exploitation of market power.
- The expectation that airports are exploiting market power is borne out by:
  - comparisons of charges levied on car rental operators both domestically and internationally against suitable benchmarks
  - examples of airports conduct which includes no genuine negotiation, unrestrained ability to pass costs onto users and no dispute resolution mechanisms.

<sup>20</sup> See A.

<sup>21</sup> San Francisco, Los Angeles, Atlanta, Chicago O'Hare, Dallas, Palm Springs, El Paso, Detroit.

<sup>22</sup> In the short term, is the balance of supply and demand elasticities that matters to pass through. In the longer term, entry and exit decisions also determine pass through and in markets with relatively free entry, near-full pass through can be expected.

<sup>23</sup> Sourced from car rental operator websites.

- There is little question that the ultimate bearers of the high airport charges are consumers of car rental services acquired at the airports.

## 3 REMEDYING AIRPORT MARKET POWER

### 3.1 The current regulatory framework is ineffectual

The ACCC monitoring regime currently only applies to aeronautical services and on-airport car parking services. It does not monitor the price and quality of services offered by airports to car rental operators. This means there are few restrictions on airports exploiting their market power in their dealings with car rental operators.

The only avenues open to car rental operators to address the use of market power is the threat of legal action under the *Competition and Consumer Act 2010* (CCA) – specifically, by:

- bringing proceedings against airports for misuse of market power under section 46, or
- by seeking declaration of airport infrastructure under Part IIIA.

There are minimal prospects of bringing proceedings against an airport on section 46 grounds – as section 46 was never designed to address monopoly pricing – rather, it only strikes at conduct which substantially lessens competition.<sup>24</sup>

Of Part IIIA, the Commission has previously argued that:

*As noted earlier, the Part IIIA national access regime was always intended to be an operative part of the light handed approach for overseeing airport behaviour — in essence, a mechanism of ‘last resort’ for resolving serious and protracted disputes.<sup>25</sup>*

The Commission has also referred to the Government’s position at the time of deregulation, where Ministers Anderson and Costello stated that:

*In the event that commercial agreement cannot be concluded in relation to access terms and conditions, the access provisions in Part IIIA of the TP Act provide recourse to arbitration for determining those conditions for ‘declared’ services.<sup>26</sup>*

In our view, it would be strange indeed if the most relevant “access term and condition” – price – was to be excluded from Part IIIA consideration. Whatever the Government’s and the Commission’s intention, the evidence that airports have been exploiting their market power with respect to car rental operators

<sup>24</sup> Clarified in a number of judgements, including in *Pont Data Australia Pty Ltd v ASX Operations Pty Ltd*, 1991, ATPR 41-109. The old section 46 test asks whether conduct involves a taking advantage of market power for a prescribed purpose, but in respect of monopoly pricing it is not substantially different from the new section 46 formulation.

<sup>25</sup> Productivity Commission, *Review of Price Regulation of Airport Services*, 2006, p. XVIII.

<sup>26</sup> Anderson and Costello, P. (Treasurer) 2002, Productivity Commission Report on Airport Price Regulation, Joint Press Release no. 24, 13 May. Available at: <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2002/024.htm&pageID=003&min=phc&Year=2002&DocType=0>

suggests that the threat of legal action under the CCA has not been an effective deterrent. There may be a number of reasons for this.

In particular, proceedings under Part IIIA are likely to be costly and time consuming, and provide little certainty of outcome. In addition, recent amendments to the CCA means that the Part IIIA declaration is likely to be more difficult for car rental operators to access. This is because:

- The criterion (a) test requires that the decision maker – whether this be the NCC, Minister or the Tribunal – be satisfied that *declaration* of an airport service would promote competition in a dependent market.
- There are two significant hurdles to an airport service declaration by car rental operators:
  - The first hurdle is that airports' primary means on using market power is likely to be through uniformly high prices. In the absence of vertical integration, a clear anti-competitive motive for such high prices is absent.
  - The second hurdle is that the market in which car rental operators compete is likely to be seen as effectively competitive. In these circumstances, it is likely to be difficult to make out a case that declaration that lowered prices would materially promote competition. High input prices – of themselves – commonly have little effect on competition in downstream markets.
- The specification that declaration specifically consider “reasonable terms” may have had the intention to address detriments from monopoly pricing, but is unlikely to, in practice, provide any additional utility to criterion (a) in relation to airports.

We further discuss the utility of Part IIIA in Appendix B.

In our opinion, there is a strong argument for strengthening the existing regime.

### 3.2 Price and quality monitoring offers little deterrence

As noted above, aeronautical and car parking services provided by major Australian airports are subject to light-handed price and quality monitoring by the ACCC. The regime is intended to provide an additional deterrent on airports exploiting their market power with respect to these services (over and above the threat of legal action under the CCA). This deterrent is the threat that the government will impose heavier-handed regulation (e.g. price or revenue caps) if the ACCC finds evidence of misconduct.

One option for addressing the market power of airports with respect to car rental operators would be to extend the current ACCC monitoring framework to include the services that airports offer to car rental operators (i.e. access to car parking and counter space). However, in our view, the deficiencies of the monitoring regime suggest that this would be not an effective solution.

The key elements of an effective monitoring regime are:

- an ability to identify, demonstrate and measure misconduct – that is, clarity around what outcomes represent evidence of misconduct, and an ability to adequately monitor outcomes and behaviour
- a credible threat of effective punishment and penalties – that is, penalties for misconduct that are suitably high and certain to act as discouragement, and which are not perceived as avoidable.

The current monitoring regime does not deliver against these critical features. In particular, the regime:

- is ambiguous in identifying misconduct – the ACCC has not been able or willing to clearly articulate at what price or profit level an airport is exploiting its market power, nor identify benchmarks against which to assess airport performance. Instead, the ACCC has focused on assessing trends in airport charges and profitability over time, but this does not directly identify whether an airport is operating at or near the efficient frontier (and hence whether the airport is earning monopoly rent)

- does not create a credible threat – the monitoring regime does not provide the ACCC (or any other authority) with a general power to intervene if misconduct has been identified. In addition, Productivity Commission reviews are not guaranteed to occur in perpetuity since there is no legislative requirement. The history of government inaction in response to ACCC concerns and past Productivity Commission recommendations adds to the lack of a credible threat.

Indeed, ACCC Chairman Mr Rod Sims now says that price monitoring without recourse to an arbitration is ill-conceived:

*[Price monitoring] ignores the need to give the parties negotiating with the monopolist some strength to their arm. They cannot threaten not to use the facility, so at least give them the threat of referring a dispute over prices or terms to binding arbitration.<sup>27</sup>*

In our view, a better option would be to adopt an alternative regulatory regime.

We understand that there is a general reluctance to engage heavier-handed regulation, such as mandatory price caps or ‘cost plus’ regulation. In view of this, the most obvious alternative is to provide a right to arbitrate a dispute in the event that commercial negotiations fail. We consider this framework in the following section.

### 3.3 A negotiate-arbitrate regime may provide a suitable remedy

Under a negotiate-arbitrate framework, airports and car rental operators would engage in negotiations to determine the terms and conditions upon which the airport would provide access to its infrastructure, and any disputes will be resolved by arbitration.

Negotiate-arbitrate models for determining terms of access can deliver economically efficient outcomes when the parties to negotiation have similar bargaining strength. If one of the parties to the negotiations has a much weaker bargaining position than the other, the stronger party can extract surpluses (such as through an excessively high access price), which would not be consistent with economic efficiency. In cases of uneven bargaining strength, a means of constraining or remove the bargaining advantages of the stronger party is required. This helps to level the playing field.

We consider that a negotiation-arbitration framework could work effectively by amending the current arrangements in two ways:

- the negotiations would (ideally) be supported by a “Code of Conduct”. This Code would define the obligations of each party during the negotiation process – for instance, require both parties to negotiate in good faith, and to provide access to information relevant to the dispute
- if negotiations are unsuccessful, one of the parties may refer the dispute to arbitration – an arbitrator would seek to determine terms and conditions of access that are economically efficient. The threat of arbitration will deter airports from exercising its market power during negotiations.

Under Australian legislation, a Code of Conduct can take the form of:

- self-regulation – a voluntary Code developed by an industry body
- voluntary Code of Conduct – prescribed under Part IVB of the CCA and enforceable if signed
- mandatory Code of Conduct – as above, but automatically binding on all industry participants.

<sup>27</sup> Mr Rod Sims, *How did the light handed regulation of monopolies become no regulation?*, 2015, available at: <https://www.accc.gov.au/speech/how-did-the-light-handed-regulation-of-monopolies-become-no-regulation>

A voluntary Code may be more palatable for airports and would be effective if it was prescribed under the CCA (and hence enforceable). However, a voluntary Code runs the risk of airports dropping out when it suits them.

In terms of coverage, the negotiate-arbitrate framework should (at a minimum) cover all airports that are perceived to have significant market power. As noted in section 2.1, this would include at least each of the major metropolitan airports in Australia, and potentially ‘tier 2’ airports. We note there is likely to be a trade-off between coverage and content; for example, if all airports are covered, then the content of the Code of Conduct may need to be at a higher level to take into account the relative resources of different airports.

The effectiveness of the framework will heavily depend on the specific obligations imposed by the Code. Based on our experience with negotiate-arbitrate models, we set out our views of the key elements for an effective framework in **Table 1**.

**Table 1:** Key elements of a negotiate-arbitrate regime

NO.	CATEGORY	DESCRIPTION
1	Good faith obligation	A general requirement for the airport to negotiate in good faith and to use reasonable endeavours to accommodate the requirements of car rental operators. Implicit within this obligation is a need to identify conduct that would be considered ‘bad faith,’ which may include: action that frustrates the purpose of the negotiations, not disclosing material facts to the other party, or knowingly providing false information.
2	Pricing rules	An efficient price for accessing airport infrastructure will reflect the efficient cost incurred by airports in providing that service (plus a reasonable rate of return). Pricing principles are commonly used in other sector (such as energy and water regulation) to ensure that service providers set prices that adhere to this general rule. A common set of pricing principles will also ensure that airports around the country apply a consistent framework for determining access prices, reducing negotiation costs and disputes.  Pricing principles may cover a range of issues, including guidance on determining an appropriate rate of return, issues around asset valuation and allocation, depreciation and asset lives, etc.
3	Information disclosure	The purpose of an information disclosure regime, in the context of a negotiate-arbitrate regulatory model, is to address information asymmetries between the provider and user of the service. This facilitates a negotiated outcome between the parties.  Where car rental operators seek to negotiate with an airport over access to airport space, a key difficulty is obtaining information from the airport that enables these companies to verify if the terms offered are reasonable. This is because car rental operators do not have visibility of the costs incurred by airports in providing the service. Such information asymmetry increases the likelihood that airports will recover monopoly rents (since there is less scope



NO.	CATEGORY	DESCRIPTION
		<p>for users to determine whether access prices are above the level required to recover costs and a reasonable return on investment).</p> <p>Some key issues to consider in designing an effective information disclosure regime includes:</p> <ul style="list-style-type: none"> <li>• Type of information – information on existing costs and future investment programs, at a level of detail sufficient to allow car rental operators to determine whether the tariffs proposed by airports reflect the efficient cost of providing the service, plus a reasonable return on investment. This includes information on asset valuation, actual and proposed capital expenditure, operating expenditure, principles for allocating costs between different services, the assumed rate of return, and other inputs used to determine access prices</li> <li>• Timing – a requirement on airports to provide information in a timely manner will reduce their ability to unnecessarily delay or protract contract negotiations, which will reduce negotiation costs.</li> </ul>
4	Negotiation procedure	Guidance around the negotiation process and timeline (e.g. when information will be provided, when consultations will take place, etc) will improve transparency and certainty during the negotiation process. Penalties for breaching these procedures will reduce the likelihood that a party will unreasonably frustrate the negotiations.
5	Arbitration process	Clear guidance on how an arbitration will be conducted will help to manage costs. In addition, there is an overarching question on the type of arbitration that would be conducted, (e.g. conventional arbitration, final offer arbitration, etc). The selection of arbitration approach will impact how the parties negotiate – this is discussed in further detail in the next section.

### 3.4 Measures can be adopted to avoid automatic recourse to arbitration

The goal of arbitration design is to induce parties to negotiate a settlement to their dispute. It has been noted that:

*...the effectiveness of any dispute-resolution system is judged by the frequency with which it leads to self-negotiated settlements.<sup>28</sup>*

There are several different types of arbitral processes. ‘Conventional arbitration’ generally means that the arbitrator is able to impose an award of his or her own choosing if negotiations end in dispute, allowing them to choose freely among a continuum of potential outcomes.

Conventional arbitration has been subject to some criticism in academic literature. In particular, it has been argued that if the parties to the dispute expect the arbitrator to split the difference, it reduces the

<sup>28</sup> Deck, Farmer and Zeng, *Amended Final-Offer Arbitration Outperforms Final-Offer Arbitration*, 9(2) American Law and Economics Review (2007) 384, at 386.

incentives for the parties to make concessions during negotiations; that is, parties may exaggerate their demands and hold back concessions in anticipation of handing the dispute to the arbitrator.

There are two reasons why we think these concerns may be unwarranted in the present case.

First, excessive arbitration is a symptom of a poorly-designed framework. Industries that have experienced excessive arbitration are typically required to determine access conditions subject to a framework that suffers from implementation issues, or substantial uncertainty. A commonly referred to example is the telecommunications sector – in this case, excessive arbitration has resulted due to practical problems in determining the total-service long-run incremental cost (TSLRIC) of providing the relevant access services (see **Box 3**).

### **Box 3: Excessive arbitrations in telecommunications was a special case**

In 2011, the Productivity Commission raised concerns with sector specific arbitration mechanisms on the basis that “...under the access regime for telecommunications, the ACCC has conducted nearly 100 arbitrations in the five years to 2009-10.”<sup>29</sup>

These arbitrations occurred under an access regime introduced in 1997 under Part XIC of the *Trade Practice Act 1974*. The access regime applied to ‘declared’ services; essentially, those services which had monopoly or bottleneck characteristics. In the first instance, prices for these services were to be negotiated between access providers and access seekers. The ACCC was able to intervene at the request of parties, for example by issuing a final determination in an access dispute.

In selecting an access pricing approach for fixed line services, the ACCC decided that access prices should be set at no more than the TSLRIC of providing the relevant access services.<sup>30</sup> This was an attempt to set prices at the efficient forward-looking costs of supply.

However, the practical problems associated with implementing a TSLRIC approach to pricing, as outlined below, effectively prevented pre-arbitration negotiations from being successful.

- Estimating TSLRIC requires a number of assumptions to be made around approach, and a general lack of agreement on how to implement a TSLRIC led to a proliferation of estimation models. This significantly increased the scope of negotiations and prospect for differential positions.
- Compared with other pricing approaches based on the depreciation of actual costs incurred, TSLRIC modelling is highly speculative and requires a greater degree of foresight (well beyond five years). In particular, long-term forecasts of future asset price changes and assumptions about obsolescence of assets. These assumptions are highly speculative particularly in the presence of rapid technological change.
- In addition to the contention that surrounded setting TSLRIC-based prices for the first time, a greater challenge emerged from how to update the costs and prices over time. In particular, this required an estimation of a ‘modern equivalent asset’ that would be built to provide service today and into the future. It is an imaginary cost of an imaginary network, and, that being the case, it can be imagined in different ways.

<sup>29</sup> Productivity Commission (2011) p XL

<sup>30</sup> ACCC (1997) cited in W. Davis, ‘From futility to utility – recent developments in fixed line access pricing’. *Telecommunications Journal of Australia*, 2011, 61 (2): pp. 32.1 to 32.16.

As a result of these issues, service providers and access seekers struggled to agree on modelling principles and inputs, and ultimately a mechanism for updating access prices over time to produce predictable and stable prices.

Source: *Frontier Economics*

In our view, the risk of excessive arbitration will be mitigated by establishing a clear and well-defined Code of Conduct. In general terms, the Code should clearly delineate the obligations on each party, and establish principles for determining access terms and conditions that are unambiguous and simple to apply. Pricing principles should be sufficiently detailed so that the parties can anticipate with reasonable certainty the outcome of an arbitration if the process were to proceed to that point. Information disclosure and transparency provisions should mitigate the information asymmetry between airports and car rental operators to allow the parties to effectively assess the efficiency of pricing proposals and identify points of dispute. Ultimately, ensuring the robustness of the Code of Conduct will reduce uncertainty that may lead to disputes between the negotiating parties, and thereby reduce reliance on arbitration.

Second, we note that the cost associated with arbitration will be incurred by the parties. This suggests that the parties will only be incentivised to seek arbitration when they feel like they are being significantly disadvantaged.

### Final offer arbitration can further encourage negotiations

An alternative to conventional arbitration is final offer arbitration (FOA). An FOA framework involves an arbitrator choosing one of the parties' proposals on each (or perhaps all) disputed issues. This differs from conventional arbitration where the parties present evidence and the arbitrator acts as fact-finder and crafts an award. Under FOA, the arbitrator is not permitted to 'split the difference' or compromise the offers of each side – he or she must select, without modification, one of the parties offers on issues of dispute.

FOA is designed to encourage a genuine pre-arbitration negotiation. Each party seeks security in agreement to avoid the risk that the arbitrator could choose the other party's offer. Put differently, the regime is intended to encourage parties to compromise and settle on the basis that an extreme offer will be less likely to be chosen by the arbitrator.

FOA has been applied in labour disputes in various states within the United States,<sup>31</sup> including negotiations over major league baseball player contracts.<sup>32</sup> It is also the legislated approach used in Canada to facilitate the resolution of rate and service disputes between carriers and shippers.<sup>33</sup> In a review of the FOA regime applying to Canadian railways, it was noted that:

<sup>31</sup> Konchon, T.A, "Dynamics of Dispute Resolution in the Public Sector", Chapter 5 in *Public-Sector Bargaining*, Benjamin Aaron, Joseph R. Grodin and James L. Stern (eds), Industrial Relations Research Series, The Bureau of National Affairs, Inc. Washington, D.C. (1979).

<sup>32</sup> Chelius, J.R. and J.B. Dworkin, "An Economic Analysis of Final-Offer Arbitration as a Conflict Resolution Device", *The Journal of Conflict Resolution*, Vol. 24, No. 2 (June 1980).

<sup>33</sup> Under Part IV of the *Canadian Transportation Act, 1996*

*... the FOA provisions have two important hallmarks of effective economic regulation: First, the arbitration process encourages parties to reach commercial settlement of their disagreement by its all-or-nothing approach.<sup>34</sup>*

For these reasons, we do not consider that direct access to a negotiate-arbitrate regime will encourage parties to expeditiously seek arbitration.

### **Arbitration creates precedents**

It may be that in early stages of the regime there would be arbitrations. This is because there is some uncertainty about key areas of dispute which cannot be readily resolved. However, arbitrations also reduce the probability of further arbitrations, because they create precedents which can be followed by the parties in future negotiations.

## **3.5 Assessing the impact of the new framework**

In our view, a robust negotiate-arbitrate framework will result in minimal additional costs (or may even reduce costs). Further, any cost increase is likely to be outweighed by the benefit of more efficient terms and conditions for access. We discuss each in turn below.

### **3.5.1 Minimal additional costs**

#### **Administration and compliance**

The proposed framework is likely to involve minimal additional administrative and compliance costs.

The costs of information disclosure will depend on the precise nature of the framework and the ease with which airports can collate and provide the require information to be disclosed. However, it is unlikely that these incremental compliance and administrative costs would be significant when compared to those incurred under voluntary negotiation. This is because airports can be expected to already collect this information in order to inform their own negotiations. Hence, the additional cost would be associated with collating it (not creating it), to enable it to be readily understood by car rental operators.

Indeed, other things being equal, we expect that the proposed framework will decrease administrative cost for both airports and car rental operators by increasing the probability of reaching agreement in a more efficient and timely manner. That is, it seems reasonable to assume that a well-defined Code of Conduct will narrow the scope of disagreement between the parties, while the threat of arbitration will truncate the time spent negotiating.

There will be additional costs associated with enabling airports and car rental operators to access independent arbitration. However, we expect these costs to be minimal. As we have discussed, direct access to arbitration will not encourage parties to always seek arbitration. In addition, airports would already be developing and presenting offers as part of the negotiation process. The incremental cost of arbitration would appear to be substantially limited to the cost of the arbitrator, and conducting the proceedings themselves. We expect this cost to be relatively small – but, in any event, a robust Code of Conduct that narrows the scope of disagreement will likely reduce the duration of any such arbitration, and thereby lower costs.

<sup>34</sup> Cited in a report prepared by InterVISTAS for Air New Zealand on Issues regarding the regulation of New Zealand's Gateway airports, section 5.5 Final Offer Arbitration: The Case of Canada's Railways and Maritime Sector

## Investment

Regulation is often associated with risks to investment. This is because, other things equal, a threat that regulators can appropriate the returns from successful investments can dissuade those investments from being made.

In our view, it is important to put the question of airport investment in context. The first and most important feature of airports in Australia is that they are privately-owned, unregulated monopolies. A basic proposition that can be found in most economic textbooks is that unregulated monopolies produce too little output, face little incentive to do better, and will underinvest to create capacity scarcity.

Of course, regulation will affect the investment incentives of a monopoly, particularly if it of the “heavy-handed” kind. But, depending on the nature of the regulatory framework and how it is implemented, the level of investment in this case may be either above, below or equal to the efficient (competitive) level.

Evidence from other industries and jurisdictions suggests that heavy-handed regulation (such as price and revenue caps) has in practice more often given rise to concerns relating to overinvestment and gold plating of airports. In these regimes, regulators generally allow service providers to recover a guaranteed return on its capital expenditure. This creates an incentive for the business to increase the value of the asset base to which the regulated rate of return is applied (by overinvesting or gold plating), and thereby increase the revenue that it may earn.

For a monopoly subject to a negotiate-arbitrate regime, it is difficult to be definitive about how optimal investment will be under this framework, due to the absence of good comparator regimes in other industries or jurisdictions. Notwithstanding, in our view, there is no basis for believing that investment will be less efficient than the current regime of price monitoring.

### 3.5.2 Benefits of more efficient access conditions

The proposed framework should deliver benefits from more fruitful negotiations that deliver more efficient outcomes. In particular, the Code of Conduct and threat of arbitration is intended to redress the market power that airports would otherwise be able to exploit during negotiations with car rental operators, which should:

- lower prices towards efficient costs
- increase the efficiency of airport investment by the airport
- increase the efficiency of airport investment by the car rental operators.

Prices for airport services that more closely resemble costs (and greater pressure on costs) will lead to a number of benefits, including an increase in consumer welfare. Pass through of benefits is relatively assured, because competition between car rental operators is strong and lower charges would directly decrease the marginal costs of all suppliers. It is difficult to predict how large these benefits will be because it requires a ‘counterfactual’ lower price to be estimated. However, it is evident from the information that AFIA has gathered from relevant members that the potential gains are not insignificant or trivial.

## A INTERNATIONAL PRICE COMPARISONS

Country	Airport Name	OAG Code	Cost Rank
New Zealand	Queenstown	ZQN	1
Australia	Sydney	SYD	2
Australia	Cairns	CNS	3
Australia	Alice Springs	ASP	4
Australia	Canberra	CBR	5
Australia	Brisbane	BNE	6
Australia	Darwin	DRW	7
Australia	Perth	PER	8
Australia	Mackay	MCK	9
Australia	Newcastle	NEW	10
UK	Heathrow	LHR	11
New Zealand	Christchurch	CHC	12
Australia	Melbourne	MEL	13
New Zealand	Auckland	AUK	14
France	Paris Roissy	CDG	15
Spain	Madrid	MAD	16
Australia	Adelaide	ADL	17
Australia	Rockhampton	ROK	18
UK	Edinburgh	EDI	19
Australia	Townsville	TSV	20
Australia	Coolangatta (Gold Coast)	OOL	21
New Zealand	Wellington	WLG	22
Italy	Rome Fiumicino	FCO	23
France	Geneva	GVA	24
Germany	Frankfurt	FRA	25
France	Nice	NCE	26
US	Palm Springs	PSP	27
Germany	Munich	MUC	28
France	Paris Orly	ORY	29
US	Los Angeles	LAX	30
US	San Francisco	SFO	31
Spain	Valencia	VLN	32
Italy	Milan Malpensa	MXP	33
Spain	Seville	SVQ	34
UK	Glasgow	GLA	35
UK	Gatwick	LGW	36
Spain	Barcelona	BLA	37
UK	Manchester	MAN	38
Benelux	Amsterdam	AMS	39
Germany	Stuttgart	STR	40
Italy	Milan Linate	LIN	41
Spain	Malaga	AGP	42
US	Chicago O'Hare	ORD	43
US	Detroit	DTW	44
Germany	Hamburg	HAM	45

Italy	Pisa	PSA	46
France	Mulhouse	BSL	47
Germany	Duesseldorf	FES	48
US	Dallas	DFW	49
France	Marseille	MRS	50
US	Atlanta	ATL	51
France	Toulouse	TLS	52
Germany	Cologne Wahn	CGO	53
Benelux	Brussels	BRU	54
US	El Paso	ELP	55
UK	Bristol	BRS	56
France	Nantes	NTE	57
Spain	Alicante	ALC	58
UK	Luton	LTN	59
France	Bordeaux	BOD	60
UK	Birmingham	BHX	61
Italy	Palermo	PMO	62
France	Lyon	LYN	63
Italy	Catania	CTA	64
Germany	Berlin Tegel	TXL	65
UK	Stansted	STN	66
Italy	Venice	VCE	67
Italy	Naples	NAP	68
Germany	Berlin Schoenefeld	SXF	69
Benelux	Charleroi	CRL	70
Italy	Bergamo	BGY	71

*Source: AFIA Car Rental Operator Members*



## B DECLARATION UNDER PART IIIA ACCESS REGIME

### Summary

Recent amendments to the Part IIIA national access regime have created uncertainty about the effectiveness of declaration as a constraint on airports' behaviour. In this annex, we examine, from an economic perspective, the possibility of car rental operators seeking declaration of services supplied by airports under Part IIIA.

Our main finding is that the new wording of criterion (a) has served to make declaration more unlikely — and therefore less of a constraint on airports' behaviour — as declaration would only promote competition in limited and unusual circumstances. Part IIIA's limited application means it could only rarely provide (if ever) the mechanism of 'last resort' for resolving serious and protracted disputes as the Productivity Commission intended.

The reasoning for this finding is as follows:

- The criterion (a) test requires that the decision maker – whether this be the NCC, Minister or the Tribunal – be satisfied that declaration of an airport service would promote competition in a dependent market.
- There are two obvious hurdles to an airport service declaration by car rental operators.
  - The first hurdle is that airports' primary means on using market power is likely to be through uniformly high prices. In the absence of vertical integration, a clear anti-competitive motive for such high prices is absent.
  - The second hurdle is that the market in which car rental operators compete is likely to be seen as effectively competitive. In these circumstances, it is likely to be difficult to make out a case that declaration that lowered prices would materially promote competition. High input prices – of themselves – commonly have little effect on competition in downstream markets.
- It is conceivable that high prices (whether uniform or discriminatory) could lessen competition in a dependent market, and that declaration leading to reasonable terms could promote competition. However, as we will discuss, these circumstances will be rare.
- The specification that declaration specifically consider "reasonable terms" may have had the intention to address detriments from monopoly pricing, but is unlikely to, in practice, provide any additional utility to criterion (a) in relation to airports.

We explain this reasoning with respect to the *Virgin Blue*<sup>35</sup> and *Glencore*<sup>36</sup> access applications and decisions of the National Competition Council, the relevant minister, and the Australian Competition Tribunal. The requisite special circumstances were present in the Virgin Blue application, but the later Glencore case reinforces that decision makers will generally take a sceptical approach to claims that competition can be promoted by lower access charges.

### Background

Section 44CA of the *Competition and Consumer Act 2010* now reads:

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<sup>35</sup> *Virgin Blue Airlines Pty Limited* [2005] ACompT 5 (Virgin Blue)

<sup>36</sup> *Application by Glencore Coal Pty Ltd* [2016] ACompT 6 (Glencore)



- (1) *The declaration criteria for a service are:*
- (a) *that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service;...*

This new wording clears up the ambiguity about the competing interpretations of the appropriate with-and-without comparison which have characterised the history of Part IIIA since its introduction in 1995. The relevant comparison is not between competition “with and without access to the service” but instead between competition “with and without declaration of the service”.

At face value, this new criterion is obviously a higher threshold than the “with and without access” approach. Few, if any, would contend that the “with or without access” approach is a higher threshold, particularly in light of the Port of Newcastle decision (which is discussed later in this note).<sup>37</sup> It remains to be seen whether the declaration-based approach to criterion (a) means that the threat of the application of Part IIIA to airports is now extinguished.

In the past, the Productivity Commission has relied on the “backstop” of Part IIIA to prevent the exploitation of market power by airports:

*As noted above, Part IIIA was always intended to be an operative part of the light handed approach for overseeing airport behaviour — in essence, a mechanism of ‘last resort’ for resolving serious and protracted disputes.<sup>38</sup>*

If it is to fulfil this function, it must be available to users. We now seek to identify the circumstances in which economics would support the declaration of an airport’s service because it would promote competition in a relevant downstream market in which the car rental operators compete.

In this note, we set out:

- The elements of the new criterion (a) test
- the meaning of competition and how it can be promoted by declaration
- the circumstances under which declaration could be expected to promote competition in markets for services supplied by car rental operators
- whether the additional requirement that access be on reasonable terms changes these conclusions

### **Elements of the criterion (a) test**

Criterion (a) has a number of elements. Four elements follow from the wording:

- the test must take a “with and without declaration” approach to the assessment of competition
- declaration must promote an increase in competition

<sup>37</sup> Indeed, the Productivity Commission reached that same view in its 2006 review. See Productivity Commission, *Review of Price Regulation of Airports Services*, No. 40, December 2006, p. 52.

<sup>38</sup> *Ibid.*, p. 47.

- competition must be promoted in a market that is not the market in which the airport holds market power from the ownership of the facility
- the conditions of competition in that identified market must be promoted to a material extent

The key economic issue is how declaration might promote competition in an environment where airports are not vertically integrated. Access (or increased access) to the facilities provided by an airport clearly promotes competition, because the facilities are clearly a bottleneck to which access must be obtained to provide an on-airport car rental service.

However, the new wording of the test emphasises that it is access because of declaration that matters. So, we must ask when and how might access “on reasonable terms and conditions” that results from declaration promote competition in the markets in which *car rental operators* compete?

## Markets in which car rental services are supplied

The first step in considering criterion (a) is to identify the market in which the access provider holds market power, and then the dependent market or markets in which competition is likely to be promoted to a material extent (the dependent market). This dependent market must be separate to the market in which the airport holds market power.

Our view is that finding a relevant market in which the airport holds market power is not likely to be a particularly contentious issue in any application for declaration. Each airport’s supply of car rental services is likely to form a relevant market.

Our reasons for this view is that airports are the only suppliers of car rental facilities at the airport. Market definition requires us to consider the substitutes to those facilities, from both the demand- and supply-side. Supply-side substitution (on airport) is not feasible. The relevant question is whether there is substitution on the demand side – from car rental operators to use off-airport facilities. Each application would require its own assessment of the facts at each airport. However, using a conventional ‘hypothetical monopolist’ approach to consider a 5-10% price increase from the competitive level, in most cases we would expect there will be little prospect of a significant enough switching effect to include off-airport car rental supply in the relevant market. This finding was supported by the ACCC in 2007 in relation to Perth Airport, and we have no reason to believe there have been any material changes since that time:

*The ACCC considers that for car rental companies there is likely to be, at best, limited substitutability between retail space and car parking space offered to them at Perth airport and that available at other locations. This is because many customers hiring vehicles at the airport are likely to want to rent a car directly after arriving in Perth by plane and/or to return a car directly to the airport before departing from Perth by plane. These customers would place significant value on the convenience of being able to pick up and/or return their rental vehicle at the airport.<sup>39</sup>*

We proceed on the basis that the dependent market is likely to be the market in which car rental operators compete to supply airline passengers with car rental services.

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<sup>39</sup> ACCC, *Objection notice to a collective bargaining application by Hertz Australia et al*, 2010, p. 10. Available at: <https://www.accc.gov.au/system/files/public-registers/documents/D10%2B3646162.pdf>. This conclusion differs somewhat from that reached in an earlier authorisation application relating to Sydney Airport, where the market was found to be “greater than Sydney Airport”. However, a conclusion on market definition was not reached. See <https://www.accc.gov.au/system/files/public-registers/documents/D05%2B12713.pdf>, p. 10.

## What does it mean to “promote competition”?

The next step would be for the applicant for declaration to demonstrate how declaration could promote competition in the dependent market identified – for passenger transport services.

As has been noted by the Australian Competition Tribunal on several occasions, competition is a multi-faceted and rich concept that defies a simple exposition.<sup>40</sup> Perhaps most succinctly, the Tribunal has described competition as follows:

1050 ...competition may be described as rivalry that amounts to a process that leads to an increase in economic efficiency.<sup>41</sup>

In our opinion, this correctly links competition with a process that leads to economic efficiency and therefore is socially beneficial.

The starting point for economic analysis of competition is conventionally the polar cases of perfect competition and monopoly. The reason this is important is that, in the polar cases, the answers on whether declaration would promote competition are relatively straightforward:

- with perfect competition, there is no prospect that declaration could promote competition because all suppliers in the dependent market act as price takers; nothing the upstream firm could do can affect prices or quantities in such a dependent market.
- with monopoly, there will usually be a strong case that declaration could promote competition (but only if access to the bottleneck input is essential to compete and declaration would improve access).

Beyond the polar and extreme cases of perfect competition and monopoly, there exists a range of more or less competitive markets and competitive market models. Most relevant to criterion (a) analysis is the intermediate case of workable or effective competition, and of competition’s antithesis, market power.

Most definitions of effective or workable competition draw on the “structure-conduct-performance” paradigm that has been widely used in industrial economics for many years.<sup>42</sup> In particular, when making judgments about the effect of a thing on competition, one will look to the effects of that thing on the structure, conduct and performance of the relevant market(s). The key points derived from this framework include that effective competition:

- is strongly dependent on the structure of the market, including the number of competitors and barriers to entry
- signifies rivalry between a number of actual and potential competitors
- prevents or strongly inhibits the exercise of market power which allows firms to ‘give less and charge more’
- is associated with higher output and lower prices compared to a less competitive market

This approach is supported by the decision of the Tribunal in *Chime No. 2*:

<sup>40</sup> See generally *Application by Chime Communications Pty Ltd (No 2)* [2009] ACompT 2 (27 May 2009)

<sup>41</sup> *In the matter of Fortescue Metals Group Limited* [2010] ACompT 2 (Fortescue)

<sup>42</sup> Often associated with the work of Scherer, see for example, F M Scherer and David Ross, *Industrial Market Structure and Economic Performance*, Houghton Mifflin, 3rd edition, 1990, p 5.

48 *What, then, do we draw from the various models for studying a market to determine its competitiveness and for assessing how the market may behave in the future? In the Tribunal's view a market is sufficiently competitive if the market experiences at least a reasonable degree of rivalry between firms each of which suffers some constraint in their use of market power from competitors (actual and potential) and from customers. The criteria for such competition are structural (a sufficient number of sellers, few inhibitions on entry and expansion), conduct-based (eg no collusion between firms, no exclusionary or predatory tactics) and performance-based (eg firms should be efficient, prices should reflect costs and be responsive to changing market forces).<sup>43</sup>*

This provides the foundation for an analysis of how declaration could improve the prospects of, or environment for, competition – where pricing or other behaviour without declaration changes market structure with the effect of reducing rivalry between enterprises, facilitating market power, or otherwise resulting in lower output and higher prices – consistent with a downstream market that is not effectively competitive.<sup>44</sup>

## The circumstances in which declaration could promote competition

Given the discussion on the promotion of competition, it appears difficult, yet not impossible, to conceive of circumstances in which declaration could promote competition.

There are two major hurdles which would need to be overcome by an applicant seeking declaration.

- The first hurdle is that the market in which car rental operators compete is likely to be seen as effectively competitive. In these circumstances, it is likely to be difficult to make out a case that declaration would materially promote competition unless there is a denial of access or discriminatory pricing.
- The second hurdle is that the primary concern relating to abuse of an airport's market power is likely to be uniformly high prices – yet in the absence of vertical integration, a clear anti-competitive motive for high prices is absent. Moreover, high input prices of themselves commonly have little effect on competition in downstream markets.

More broadly, we would expect that car rental operators may be able to pursue the argument that declaration could promote competition in a downstream market for passenger transport services where:

- an airport denies access to a car rental operator
- the airport is engaging in a degree of price discrimination towards particular car rental operators
- increases in charges have been sufficient to lower existing car rental operators' output and/or raise prices in downstream markets, or to raise barriers to entry to new entrants.

## The first hurdle – an effectively competitive downstream market

In most larger Australian airports, there are a number of suppliers of car rental services – usually 5 or more. The services offered by the competing suppliers are only mildly differentiated, and price competition for rentals is evident. In these circumstances, we consider it highly likely that the market would be considered effectively competitive, and that car rental operators are price takers.

<sup>43</sup> Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2 (27 May 2009)

<sup>44</sup> Noting that the Tribunal said in Fortescue that: "The position we take is that if a dependent market is already effectively competitive, intervention is not called for." At [1068].

The implication of such a finding is that decision makers are much less likely to consider criterion (a) to be met where there is already effective competition downstream. As noted by the Tribunal in Fortescue:

*The position we take is that if a dependent market is already effectively competitive, intervention is not called for.<sup>45</sup>*

In effectively competitive markets, it will take quite extreme changes to the terms and conditions of access (whether due to declaration or otherwise) to reach the requisite threshold of a promotion of competition that is material. That is, it might require evidence of:

- a denial of access to one (or likely more) car rental operators
- discriminatory pricing that strongly favours the operations of a particular car rental operator.

There is, however, no obvious reason why the airport would wish to undertake these anti-competitive strategies compared to a strategy of simply charging high prices. It would mostly seem to derive little benefit from doing so. The Virgin Blue case indicates that exceptions might arise – although it is clear that with (at the time) only two domestic suppliers of airline services, a case that declaration could promote competition was easier to identify.

### The second hurdle – lower prices do not necessarily promote competition

The most likely way in which airports will use their market power is by charging high prices. However, as the Tribunal has noted (citing Hilmer), high prices of themselves commonly have little effect on competition in downstream markets:

*The reason is that the effect of monopoly pricing is simply to raise the price of one of myriad input prices. When one of an industry's costs goes up, there is no presumption of an adverse effect on competition.<sup>46</sup>*

It follows that a car rental operator would need to demonstrate both that terms offered by the airport are unreasonable (to indicate some difference between terms offered with and without declaration), and that there is something unusual about those terms beyond them being unreasonable.

### How easy would it be to demonstrate that terms are unreasonable?

The terms of the new criterion add in an extra feature which may assist with the inquiry into whether declaration promotes competition. This feature is that that declaration is presumed to give rise to “reasonable terms and conditions” of access.

The formulation might *appear* to invite an inquiry into what the terms of access would be under declaration; however, the Government’s explanatory memorandum to the changes states that:

12.21 *What are reasonable terms and conditions is not defined in the legislation. This is an objective test that may involve consideration of market conditions. It does not require that the Council or Minister come to a view on the outcomes of a Part IIIA negotiation or arbitration. The requirement that access is on reasonable terms and conditions is intended to minimise the detriment to*

<sup>45</sup> Fortescue, at 1068.

<sup>46</sup> Ibid, at 133.

*competition in dependent markets that may otherwise be caused by the exploitation of monopoly power.<sup>47</sup>*

From this statement, it appears that the Government has in mind that declaration that reduces the exploitation of monopoly power can reduce detriments to competition in dependent markets. This is line with the analysis we have presented. That is, it would not be a defence for a bottleneck monopolist to say: we charge high prices to all so competition *cannot* be affected.

Unfortunately, while we might agree with the sentiment expressed, it is likely to be very difficult for the NCC, Minister or Tribunal to conclude that the current terms of access are unreasonable, and to specify what more reasonable terms and conditions might look like. This is so even for airports that are subject to monitoring using regulatory accounts.

An obvious issue is the value to place on an airport's assets, and the rate of return that an airport could reasonably earn on those assets. The ACCC has concluded in relation to its monitoring of airports that:

**A4.3.1 Monitoring information cannot be used to assess the appropriateness of the level of prices and profits**

*When assessing the level of prices and profits, it is common regulatory practice to undertake an assessment of the firm's economic returns against their efficient long-run costs for providing services. This may involve a public process to rigorously determine an economic value of the firm's asset base (i.e. the regulatory asset base (RAB)) and the firm's required rate of return on capital (i.e. the weighted average cost of capital (WACC)). In the case of airports, however, the benchmark for efficient long run costs has not been set. Instead, the airports' asset values under monitoring are based on their accounting values rather than their economic value. Importantly, the accounting value of assets may include revaluations that have been undertaken at the airports' discretion and that can distort assessments of airports' performance.<sup>48</sup>*

To take a further example, airports are multi-service enterprises that use a common set of assets, such as terminals and landside areas. How airports allocate their common costs between services can result in very large price differences – which may or may not be reflective of unreasonable terms.

We conclude that, without detailed regulatory accounting and guidance on key pricing parameters, the burden of showing that prices are not reasonable – and so should engage a comparison with lower reasonable prices - is likely to prove an overwhelming burden for applicants and decision-makers.

<sup>47</sup> Explanatory Memorandum to the *Competition and Consumer Amendment (Competition Policy Review) Bill 2017*, at 12.21.

<sup>48</sup> ACCC, *Airport monitoring reports 2016-17*, Appendix A, p. 189.

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